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MARKET-BASED PERESTROIKA HAS NOT FAILED; IT HASN'T BEEN LAUNCHED

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SUMMARY

A year ago the world was in a state of euphoria over Gorbachev as a result of his startling foreign policy decisions to pull the Soviet military out of Afghanistan, allow the demise of Communism in Eastern Europe and give the green light to the reunification of Germany. Chancellor Kohl and others in the West proposed that the West extend a new Marshall Plan to the Soviet Union to ensure the success of Gorbachev's economic reform process perestroika. Twelve months later in the wake of Gorbachev's bloody crackdown in the Baltic and increasing reliance on conservative, anti-reform forces, some in the West have reversed course and called for taking away Gorbachev's Nobel prize and for a cut off in all economic aid to the USSR.

Gorbachev launched perestroika to revitalize the USSR's stagnating and technologically backward economy. Six years of perestroika, however, have only made the bad economic situation Gorbachev inherited in 1985 even worse. Gorbachev has steadfastly resisted market reforms culminating in his rejection last October of the bold "500-day" Shatalin plan for a rapid transition to a market economy. The failure to implement market reforms in the Soviet Union stems mainly from Gorbachev's firm conviction in Communism, the tremendous resistance from the nomenklatura and from the dismay of the Soviet populace.

In the short term, the West appears to have very little direct leverage to encourage market reforms in the USSR. However, an indirect approach involving additional Western economic assistance to Eastern Europe, channeling aid to the reform-minded republics, and letting the IMF take the lead in insisting on conditionality for further Western financial assistance could promote the Soviet reform process.

ISSUE DEFINITION

The United States and the rest of the West desire to see a Soviet economic reform process based on market principles be put into effect. Such a development would create a more open Soviet society, transfer resources to non-military purposes and promote the USSR's integration into the world economy. Gorbachev's policy of perestroika, however, still aims at revitalizing, not dismantling, his country's flagging Communist command economy. The question is what leverage does the West have to bring about a market-oriented system in the Soviet Union, particularly in light of Gorbachev's increasing reliance on the traditional pillars of Communism.

BACKGROUND

The Genesis Of Perestroika

Shortly after coming to power in 1985, Mikhail Gorbachev initiated his economic reform process known as perestroika in order, as he phrased it, "to avert serious social, economic and political crises." By the mid-1980's, economic growth in the Soviet Union had virtually come to a standstill and excessive military spending was consuming about 20-25% of Soviet GNP. Soviet technology had become increasingly backward and the Soviet Union seemed on the verge of becoming a third world country confirming German Chancellor Schmidt's earlier quip that the USSR was really only "Upper Volta with rockets."

To Gorbachev's credit, he recognized that the Soviet Union's reliance on overcentralized extensive economic growth policies (i.e. the utilization of ever increasing inputs of capital, labor and land without concern for efficiency) had resulted in "inertia" and was leading to "economic deadlock and stagnation." Gorbachev thus launched perestroika in order to modernize

the Soviet economy and prepare it for the challenges of the 21st century.

Going In Circles

Six years of perestroika, however, have been an abysmal failure. The Kremlin has officially conceded that Soviet GNP dropped by 2 percent last year; no end of the USSR's grave economic recession seems in sight. Shortages of such basic goods as bread and milk have plagued the Soviet public, and inflation is on the rise due primarily to the Kremlin's huge budget deficit amounting to 12% of GNP (budget deficits of 4-5% of GNP cause heartburn for governments in the West).

The main problem with perestroika is not that it has failed in its implementation of market-oriented reforms, but that such reforms have never been launched. The mishmash of economic changes that Gorbachev has implemented have all been half-measures - neither fish nor fowl - which have served only to make USSR command economy even less workable. For example, Gorbachev ordered managers of state firms to make contracts directly with each other, instead of through planners in Moscow, but then issued them "priority" state orders that have to be filled first and that still account for about 90% of total orders.

Last fall it seemed as if Gorbachev was beginning to flirt with market reforms. He gave the green light to his chief economic adviser Stanislav Shatalin to draw up a new blueprint for the Soviet economy. Shatalin produced a radical "500-day plan" that aimed at a rapid transition to a market economy via the decontrol of most prices, far-reaching privatization of government enterprises, and hefty cuts in government subsidies and defense spending. However, in October Gorbachev shelved the plan and since then has moved decidedly in the opposite direction.

In December Gorbachev was asked by a Western reporter if he was moving to the right (to rely more on conservative, anti-market reform forces); Gorbachev replied that he was not moving to the right but "only going in circles." The changes that Gorbachev has implemented since rejecting the Shatalin plan will truly keep the Soviet economy going in circles and offer no hope for an economic recovery. In January Gorbachev's Prime Minister Pavlov ordered the confiscation of high-denomination currency notes which burned pensioners more than blackmarketers but shattered the Soviet citizens' confidence in the ruble and the country's banking system. Then he tried to blame the confiscation on the need to take action against certain Western banks which, he said, were planning to flood the Soviet Union to create economic chaos; such an absurd statement only served to sour further foreign investors' view of the USSR. Now the Kremlin has announced that it plans soon to raise prices on most basic consumer goods by 60%, offset in part by hikes in wages and pensions. The government will retain its monopoly control over prices. Such a package has nothing to do with a market economy; it will simply boost inflation without making more goods available in stores.

ANALYSIS

The failure of the Soviet Union to start a transition toward a market economy can be attributed to three main factors: Gorbachev's "faith", the vigorous resistance from the traditional pillars of Soviet society, and the dismay of the Soviet populace over the dismal results so far of perestroika.

Gorbachev The True Believer

The most salient reason why no meaningful steps toward market reforms have been taken in the Soviet Union is that Gorbachev remains, as he recently reaffirmed, a "convinced Communist." The main aim of his policy of

perestroika has always been to revitalize, not dismantle, the Communist centrally-planned economy. Many people in the West, who saw Gorbachev as the ultimate guarantor of an eventual transition of the USSR to a market economy and democracy, erred gravely in not taking Gorbachev at his word.

In his 1987 book on perestroika, Gorbachev explicitly affirmed his "indomitable commitment" to the Leninist economic principles, a position on which he has not wavered since then. In his view, the Soviet Union's profound current economic problems stemmed from Stalin's and his successors' straying from the Leninist path by overbureaucratizing the Soviet economy and relying on a failed policy of extensive economic growth. "The inertia of extensive economic development was leading to economic deadlock and stagnation (in the USSR)."

However, Gorbachev specifically rejected capitalism by declaring in his book that "any hopes that we will begin to build a different, non-socialist society and go over to the other (Western) camp are unrealistic and futile; those in the West who expect us to give up socialism will be disappointed." Socialist public ownership, he asserts, holds out "virtually unlimited possibilities for progressive economic processes."

Gorbachev is thus very much a tragic figure in that he has so far been unable to jump over his past to realize that there has never been an example in the world of a successful centrally-planned economy. In this light, it becomes clear that Gorbachev rejected Shatalin's "500-day" economic reform plan last October because he realized that its goal of a rapid transition to a market economy would lead to a total dismantling of the USSR's centrally-planned economy and a possible dissolution of the USSR.

The Intransigence Of Soviet Society's Traditional Pillars

Even if Gorbachev had been able to leap over his past to recognize that only a free market would be able to deliver a higher living standard, he was bound to run into intense resistance from hard-liners in the military, KGB, Communist Party and the government bureaucracy, who have prospered most from the old command economy system and thus have the most to lose. Shatalin's "500-day" called for an immediate 10% cut in defense spending, an even larger 20% cut in the KGB's budget, rapid privatization, and the elimination of most price controls, all of which would seriously undermine the power and perks of these traditional pillars of Communism in the USSR.

The Failure To Convert The Soviet Populace

"The most important thing for the success of perestroika," Gorbachev proclaimed in his book, "is the people's attitude toward it." As Hedrick Smith has pointed out, the less charitable qualities in the Russian character - "their escapism, their impracticality, their lackadaisical attitude toward reform and vicious envy of people who try to get ahead" - pose formidable obstacles to market-oriented reform.

In the eyes of the average Soviet citizen, perestroika has led to the disappearance of milk, bread and other essential commodities from the stores, high inflation, a worthless ruble, and negative economic growth. Even though Gorbachev has shied away from any concrete market reforms, many Soviet citizens unfortunately associate a market economy with the negative developments of growing corruption, blackmarketering, and violence. There appears to be a widespread belief among the Soviet populace that the old command economy system was not good, but it was at least better than today's economic mess. The increasing public support for law and order is really a

call for the institution of an economic system that at least half works.

RECOMMENDATIONS

In the short run the United States has little direct leverage to encourage Gorbachev to implement concrete market reforms or dissuade him from his commitment to at least a partial retreat from the glasnost reforms. Although our trade with the USSR doubled between 1986-89, it still accounted for only a minuscule 1% of total U.S. trade in 1989. Moscow has already almost fully utilized the $1 billion emergency food aid credit the Bush Administration extended last December. At this point, the best way to foster a real transition to a market economy in the Soviet Union over the longer run would be an indirect approach including three basic elements:

--Consolidating The West's Strategic Gains In Eastern Europe

The transition to democracy and market economies in Eastern Europe remains very fragile and difficult. Falling real wages, rising unemployment, and a significant drop in production have afflicted all these countries. The danger is not that they will revert to the discredited Communist systems of the past, but that falling living standards could lead to domestic turmoil and perhaps authoritarian governments. The West's economic assistance to Eastern Europe has so far been paltry. For example, U.S. direct economic assistance to the Eastern European countries last year totalled only $300 million or 1/20 of the aid given to Israel. Since all of the Western countries are under serious budget constraints, the best way to help Eastern Europe would be via forgiveness of official debt to countries that implement far-reaching market reforms. A democratic and economically prosperous Eastern Europe would serve as a magnet on the USSR, just as Western Europe's strength did vis-a-vis the former Communist regimes in Eastern Europe, since

it would prove to Soviet citizens that bankrupt Communist command economies can be successfully transformed to prosperous market economies.

--Direct Assistance To The Soviet Republics

Where possible the United States and the West should channel economic and assistance to elected leaders in the republics and local governments. The impetus for change to a market system is coming from the republics and local governments, not from Moscow. Estonia has already decontrolled local food prices and food shortages and waiting lines have disappeared in the republic. Boris Yeltsin remains committed to radical reform and his legislature has draft legislation under consideration which would allow for private property, including the right of selling, heretofore forbidden in the USSR.

--Let The IMF And World Bank Take The Lead

The USSR's hard currency debt has doubled over the past 5 years to $56 billion. The ongoing Soviet economic recession and falling prices for oil, the source of most of the USSR's hard currency earnings, mean that sooner or later Moscow will probably have to tap into the IMF and other Western credit sources for needed cash. Politically, it is much easier for Moscow to accede to market-reform conditions imposed by the IMF than by the West.

WEAKNESS OF RECOMMENDATIONS

Gorbachev's bloody crackdown in Lithuania and Latvia and increasing reliance on the anti-reform forces in the security organizations, bureaucracy and Communist party have led many to call for sanctions against the Kremlin. Clearly a successful Baltic movement for democracy and market economies would have more to do with the much vaunted new world order than the restoration of the Emir of Kuwait to power after the Gulf war. However, the type of economic punishment that some envision against Gorbachev for his

Baltic crackdown could end up harming the reform movement in the USSR more than aiding it. Even Gorbachev's arch rival Yeltsin argues the "West should take a constructive position (toward the Baltic problem); confrontation, locking horns, what does that do." Though the U.S was able to send medical shipments recently directly to the republics, other forms of assistance to the republics disagreeing with the Moscow's policies may prove difficult, but still worth trying.

Debt forgiveness for Eastern Europe has already run into strong resistance from Europeans who are worried it will set a bad precedent for the rest of the world. However, what better example for the rest of the world is there than Poland's big bang plunge toward capitalism. The Polish government has requested that 80% of its official debt of $33 billion should be cancelled; backing such debt relief, Congressman David Obey rightly argues that "the best demonstration that we can make (toward the USSR) is to show how radical reform works in Poland." The Bush Administration appears willing to grant Poland forgiveness on 65% of its official debt, but the Europeans want to grant the Poles only 40% debt relief and Japanese none at all.

STRENGTH OF RECOMMENDATIONS

The future of the Soviet Union continues to be the most important geopolitical question facing the United States because the USSR remains the only country in the world that can threaten the survival of our country. An indirect approach toward encouraging the USSR to implement market reforms allows us to remain constructively engaged with the Kremlin on resolving world problems such as in Afghanistan and Cambodia and on reaching arms control agreements. Last December the IMF, World Bank, EBRD and OECD jointly issued a report declaring that additional Western financial assistance at

this time would simply lead to money down the drain until the USSR embarks on a major and comprehensive market-oriented reform program. Sooner or later Gorbachev or his successor will realize that one can not square a circle and that only a free market can deliver higher living standards.